Entry, Conduct and Regulation in Professional Markets

Prepared by
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for
The Professional Organizations Committee

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INTRODUCTION

The purpose of this report is to assess the effects of the self-regulation of entry and conduct in the four professions that are of concern to the Committee; accounting, architecture, engineering and law. The authority to regulate each of these professions is delegated to the profession itself by the province. That authority includes the right to control entry into the profession and the ability to restrict the behaviour of the practising professions in a variety of ways. Students of regulation have argued for many years that self-regulation of this type is subject to potential abuses. The list of possible adverse consequences has been extended over time. A reasonably complete catalogue of potential problems would be both lengthy and confusing. It would provide little guidance to the Professional Organizations Committee, whose interest is in the question, "How well do these markets perform, and in those areas where performance is improvable, what are the required changes in the regulatory environment?"

These markets are unlikely to perform perfectly by competitive standards because of the pervasiveness of imperfect and incomplete information in subsets of markets. These informational gaps have lead not only to the regulation of entry into the professions, but also to a variety of kinds of institutional adaptation. Because quality is difficult to observe directly, firms with established reputations develop on the supply side. This product differentiation simultaneously

provides information to consumers and confers market power on the suppliers; the former is a benefit, the latter a potential problem.

The fact that these markets, like others, adapt and evolve to solve informational problems, does not imply that they should be left to do so under the existing regulatory regime. But it does suggest that a simple attempt to make the professions "more competitive" in all respects may not be appropriate. It is not uncommon for analysts to admit that unregulated entry into the profession would not be desirable because of consumer information problems, but then to argue that the regulation and limitation of competitive conduct, practised by all the professions must be harmful. It may be. But the factors that make unregulated entry undesirable may also cause unregulated competitive conduct to lead to undesirable results. The view taken here is that the particular characteristics of the professional markets under review, justify some restrictions on practising professionals, but not all of those currently in effect. This conclusion rests upon judgments about the structural characteristics of the professional market. These characteristics and their implications for performance under a variety of regulatory regimes are the principal focus of this report.

It is useful in a report of this kind to state the general character of the conclusions at the outset. They are based upon a review of the facts and analysis so far commissioned by Professional Organizations Committee and by other researchers in the field.[2] The arguments that lead to these conclusions form the substance of the report. The more important conclusions are the following:

1. The elimination or reduction of the incentive of professionals to <u>innovate</u>, both in the area of developing new markets and market

segments, and in reducing costs of established services, is, in the view of the author, the most important potential problem area.

2. The failure to innovate at a rate that is achievable, given the high level of talent of the members of the professions, is largely the result of restrictions on professional conduct, particularly those that pertain to advertising and marketing, and to the form and content of the "firm".
3. These restrictions on conduct are imposed to protect professions and the public from certain adverse consequences of competition.
4. The exposure of the professions to increased competition as a result of the recent amendments to the Combines Investigation Act is not necessarily in the long-run interest of the public or the professions. In particular, the exposure to price or fee competition has potential adverse effects, including the loss of able professionals in the market segments serving non-corporate clients.
5. It is important to remove the rigid restrictions on advertising, marketing, and the institutional forms by which professionals can practice, while not sweeping away all the regulatory behaviour that is designed to circumscribe price competition.
6. The regulation of entry to the profession is not inappropriately restrictive at the present.
7. In some markets there are substantial mobility barriers to certain segments, particularly those serving large corporate clients and the government. These barriers result from product differentiation based on reputation, which serves an economic function in markets with potentially imperfect buyer information. The

barriers can be reduced somewhat by regulatory action, but not eliminated.

8. There is a third issue with respect to entry. It concerns the entry of people without professional certification, to the markets for certain kinds of services. One has in mind here paraprofessionals of a variety of kinds. Neither points 6 nor 7 is intended to imply that the foreclosure of certain market segments to those who are not members of the profession is appropriate.[3]

9. The interest of the members of the public in professional performance extends beyond their interest as individual clients. These interests are inadequately represented in the regulatory process, at the present time.

REGULATION

The regulation of professional markets is a response to two structural conditions. The first is that a fraction of consumers of professional services are imperfectly informed about the attributes of the services and of the suppliers, about their needs for the services, and about the location of the suppliers whose services they perceive they need. It is believed that a completely unregulated market would result in the purchase of low quality services. It might also lead to the purchase of unnecessary services. There would be a problem attracting talented people to the professions. The historical problem in the professions suggest that these worries are not without foundation.

The second structural problem is that individuals other than those buying the services have a stake in the quantity and quality of pro-

fessional services that are delivered. There are external effects of transactions between professionals and clients. There are many examples of these external effects. Building safety, court costs, and the information available to investors are examples. They are interests that are affected by the practice of professionals. But they are not client interests.

These two structural conditions, imperfect information and external effects, suggest that demand should not be the sole determinant of the quality, quantity and character of services delivered on these markets. And while demand is not set aside, it is supplemented by the direct regulatory control of the supply side of the market, and to some extent the demand side as well.

The authority to regulate, which formally resides in the provincial government, is commonly delegated to professional organizations. There is usually one principal regulating body. It consists of members of the profession. Its regulatory purpose is to represent the interests not only of the members of the profession, but also their clients, other members of the public, and the government or public sector, insofar as certain aspects of the public interest are most closely identified with the public sector. This delegation of authority is based on the view that control over quality is best exercised by those best able to discern quality differences, namely professionals themselves.

The authority of the professions to regulate themselves covers two fundamental aspects of the market: entry and conduct or behaviour. Both entry and conduct are included within the regulatory authority because both entry and professional conduct affect the quantity

and quality of the services delivered to clients and consumers. But entry and conduct also affect prices, incomes, forms of practice, innovation and a variety of other aspects of the performance of the markets.

The interests of professionals, clients and other members of the public are neither perfectly coincident, nor completely at odds. As they are not coincident, one is lead to ask how, and how well, the professional regulatory bodies balance the interests of these various groups in framing their rules. Among analysts, the more suspicious assume the balance is tilted toward the profession itself and away from clients and the public. The argument is that the members of the regulatory body identify more with the profession (being drawn from the ranks of the profession), and less with the public. This is an odd argument. Professionals are also members of the public and presumably identify their interests with at least a subset of the public. The mere fact of self-regulation is not by itself a sufficient cause for poor market performance.

It should be added that the authority to regulate is not unlimited, and is subject to change from time to time. For example, the recently amended Combines Investigation Act appears to curtail the authority of the professions to regulate conduct in several different areas.[4] This is a subject that will occupy our attention further, because it has potentially important implications for professional conduct and for the markets they serve.

THE REGULATION OF ENTRY

All of the professions of concern to the Professional Organizations Committee regulate entry by requiring educational and

other standards to be met by the potential entrant.[5] Within the limits of the competence of the layman to judge, these standards appear to be reasonable. That is to say, to the best of one's ability to judge, the educational requirements include training in matters that are relevant to and necessary for the range of tasks that the professional may be required to perform. Neither do the educational requirements seem excessively onerous, in time or expense, in view of the subsequent returns, and by comparison with other fields of endeavour. One could perhaps quibble with the length of some of the "work experience" requirements; but that is an issue of detail. I should add that these remarks concerning entry requirements are not intended to pre-judge the important issue of whether less completely trained "paraprofessionals" might not provide high quality service in selected segments of professional markets, at a lower cost.

Although knowledgeable clients claim that there are significant quality variations among professionals in many segments of these markets, there is no systematic evidence of the presence of substantial numbers of unqualified or incompetent professionals. Moreover, a limited amount of incompetence and larger amounts of quality variation are typical of most markets for services delivered by people. It would be unreasonable to expect professional markets to differ drastically in those respects.

The most common argument against self-regulation is that it will be used artificially to restrict the supply and therefore to raise prices and incomes.

Accounting, architecture, engineering and the law in Ontario do not appear to have this problem. The evidence we have available is of the following character:

Architecture is characterized by periodic and possibly chronic excess supply and its corollary, underemployment. The excess supply situation has occurred in spite of significant and lengthy educational and experience requirements for entry into the profession. Parenthetically, the underemployment in architecture seems to result in part from restrictions on conduct that prevent architects from diversifying into new areas. I prefer to postpone further consideration of this problem to the subsequent discussion of conduct.

The accounting profession does not appear to have high barriers to entry into the profession. The range of educational programs available to prepare for a career in general accounting, and for the chartered accounting examination, is large. Entering the educational component of the process appears to be easier than it is in most other professions. There is no evidence that the flow into the profession is artificially restricted or that the average incomes of professionals across the profession reflect overall supply shortages.

Engineering has historically suffered periodic excess supply. The capacity of the educational system to produce engineers is large in relation to demand. Further, the engineering profession has effective reciprocal arrangements among provinces that permit the free movement of professionals across the country, so that temporary market imbalances can be quickly corrected.

Law is somewhat less easy to characterize. The demand for places in law schools is extremely high. Evidence from the United States suggests cycles in supply and demand, and a projected excess supply condition in the late 1970's and early 1980's. But the historical evidence does not indicate that ordinary market forces are impeded by artificial barriers on the supply side.[6]

It should be noted that with the possible exception of architecture, the professions of concern here have what might be termed 'escape valves'. These are alternative forms of employment into which professionals move in response to market conditions. For example, engineers, lawyers and accountants figure prominently among the ranks of business management. Their training and professional experience permit them to move at relatively low cost into attractive non-professional forms of employment. Unlike physicians, these professions are less locked-in to the professions for which they have trained. As a result, the incentive carefully to control the flow of new entrants is reduced, and the problem of artificial entry barriers less likely to occur.

MOBILITY BARRIERS AND INTERNAL SEGMENTATION

In all of the four professions, the markets are segmented by type of service, by type of client, and by type of reputation of the professional firms. The client surveys strongly suggest that the reputation of established firms is a significant determinant of the client's choice of supplier. In economic terms, there are significant product differentiation advantages to established firms based upon reputations built up over time. These product differentiation advantages create barriers to mobility of professional firms.[7]

A mobility barrier can be thought of simply as an advantage that a firm or group of firms has acquired, that makes it difficult or costly for new firms to enter the segment served by the established firms. Mobility barriers are by no means unique to professional markets. Mobility barriers based on established reputation advantages are common. One need look no further than IBM's dominant position in the computer

industry for an example.[8]

This form of product differentiation results naturally from the informational structure of the markets. Even experienced clients who purchase large volumes of professional services require time to learn about the abilities and qualities of a new firm. The effect of imperfect buyer information is to isolate to some extent the established large firms from competitive market conditions in general and the supply conditions in particular.

There are several observations that should be made concerning product differentiation. First, it is a natural institutional response to imperfect buyer information, and is unlikely to disappear unless alternative sources of buyer information are made available. An example of an alternative information source would be an evaluation of professional firms by an organization like Consumers' Union. This sort of report is available in consumer goods markets, and in the view of retailers, sometimes has a significant impact on the relative market shares of competing products. Second, since the established firm segment is relatively isolated from competition, the smaller firms and individual practices absorb most of the impact of changes in market conditions. Such changes include shifts in demand and supply, but also changes in the regulatory environment, like the <u>Combines Investigations Act</u> revision. Third, the informationally-based mobility barriers strictly apply to firms. Established firms can and do absorb new professionals. However, the inflow of professionals to the segment served by established firms would likely be greater were there more such firms; that is, if the barriers were lower. The impact of mobility barriers on individual professionals therefore may not be negligible. But it is indirect.

The internal segmentation issue has been the subject of considerable recent controversy. Some of it deserves comment.

The product differentiation advantages of established firms result from a real need for information by clients. Both the continuity and quality control of established firms generate perceived consumer benefits which the latter may prefer to pay for than give up. Nevertheless, regulatory activity designed to improve the flow of information to consumers would yield positive benefits. It would lower the market power of established firms without reducing the quantity and quality of the information available to consumers. It is worth noting that not only clients, but also clients of clients, care about the reputations of established firms. A corporation has a stake in being audited by a highly regarded auditing firm.[9] Independent evaluation of the performance of professional firms, if widely available, would reassure not only potential clients, but also their clients and interested third parties.

The established firm segment of the professions with which we are concerned, generally serves the larger and more powerful corporate clients or the government. Moreover, the professions serve not only their clients, but they also represent other aspects of the public interest. This role brings them in conflict with clients. In the accounting profession, the dual roles are particularly clear. These facts have been thought to imply a benefit to concentration on the selling side as a counterweight to the market power on the buying side. Or to put it differently, if more competitive small firms audited large firms, the power of the latter would tilt the balance in their favour, and against the interests of the financial community, the taxing authorities, and other non-client interested parties.

While the argument sounds plausible, there are, I believe, reasons for questioning it. The detailed study of the accounting profession in the United States [Canada is similar in the relevant respects] carried out by the Congress, suggests that the large firms [the so-called "big eight"] dominate the standard setting process. They further consult for the Fortune 500 firms on matters other than auditing, and they represent their clients before the government with respect to taxation and other matters. It is not therefore clear that matching size with size has resulted in the requisite differentiation of interests of clients and auditors.

It seems to this observer that whatever the merits of the established firms, countervailing power is not sufficient to ensure that the evolution of accounting standards meets the needs of the investing community. The pressure on professional firms should and must come from the regulatory bodies and the courts. It is not sufficient to rely on countervailing power in the marketplace. Countervailing power in this and other areas has a tendency to transform itself into cooperation, and a perception of common interests. In the specific case of accounting, the direct representation of the interests of financial and the investing communities in the process of setting accounting standards has been limited.

One might argue further that when the power of the regulatory body is challenged by that of the dominant firms, or when the dominant firms exercise a significant influence on the composition of the regulatory body, then the interests of consumers are less likely to be represented adequately. The Metcalf report argues that this may have been the case in the United States, in the accounting profession.[10]

This suggests that the countervailing power argument might be more appropriately applied to the relation between professional firms and the regulatory bodies, where a mismatch of power can occur.

While these remarks apply most directly to accounting, similar considerations apply to engineering and architecture. Both of the latter professions are responsible to the public for adequately designed and safe structures. In both cases the balance in the regulatory organizations is tilted heavily toward representation of the public interest by the profession.

I should like to emphasize that this discussion is not intended as a criticism of current standards in accounting or the other professions. Such a judgment would have to be based upon professional expertise not possessed by this author. The argument is rather that the product differentiation mobility barriers in the segments of the professions that serve large corporate and government clients have the side effect of creating a concentration of power in the relevant segments.[11] The power is sometimes justified as a counterweight to the comparable economic power of the clients. A more effective counterweight would be a regulatory body within the profession to balance the inevitable power of established professional firms and their clients.

THE REGULATION OF CONDUCT

The second major area of regulation in the professions, and the more important in determining their performance at the present time, are restrictions on the behaviour and conduct of practising professionals. The formal justification for these restrictions is that they are required to protect the interests of imperfectly informed clients and the public, much as the maintenance of reasonable standards for entry

into the profession. The restrictions on conduct cover a wide range of behaviour, and there are differences in detail among the professions. Price cutting is sometimes controlled directly or informally by the maintenance of fee schedules. There are prohibitions against many forms of advertising and marketing activity, the solicitation of competitors' clients and so forth. There are also rules specifying professional misconduct of other types. The rules also cover the extent of professional liability, and the procedures to be followed in case complaints are registered.

The rules enforcing acceptable ethical standards of conduct are uncontroversial. For our purposes, the controversial issues, the ones that require attention, are those that limit competitive behaviour.

In reviewing the literature on this subject, one finds a tendency among analysts to criticize _any_ attempt by collective action to circumscribe or limit competition in the professions. The basis for these judgments seems to be that competition is desirable and to be promoted under all circumstances. This prejudice is neither reasonable, nor fair to the professions. Nor does it accord well with the view that, for structural reasons, controlling entry is justifiable. It is useful to recall that the regulation of entry is deemed appropriate on the ground that there exists potentially serious informational problems facing consumers. While it may not be desirable to extend that regulation to certain forms of conduct, it does not follow that unrestricted competition is desirable in a market that in other respects does not meet the conditions for an effectively functioning competitive market.

The view developed here is that there are legitimate reasons for constraining competition, but that the manner in which it is currently

accomplished has costly side-effects, principally that of reducing the return to innovation and the incentive to engage in innovative behaviour. The regulatory problem is to refine our sense of the benefits and costs of competition, and to develop, in partnership with the professions, codes that meet the needs of professionals and clients, but that avoid the undesirable consequences of the current restrictions on conduct.

THE DETERMINATION OF PRICES AND INCOMES

The professions have all taken steps to control price competition. The stringency of the measures vary considerably from profession to profession. Fee schedules are not uncommon. Many kinds of marketing activity are frowned upon or prohibited. Moreover, in responding to critics and arguing for the right to restrict price competition before the courts, professional organizations exhibit a serious concern with this aspect of professional conduct. This concern has appeared to outsiders at times to be excessively self-interested. It is argued here that there are legitimate structural problems associated with the determination of professional prices and incomes, by competitive forces.

First, a professional's operating costs consists largely of his or her own time. For the individual committed to professional practice, these costs, for a normal working week are not high. The professional incurs substantial fixed and sunk educational costs in the course of entering the profession. The latter include the education itself, the foregone income in the period of education, the period of apprenticeship and the costs of developing a practice. Unless the supply is matched perfectly over time to demand, the prices in a competitive market could easily fall to a level that provides less than a reasonable return on the investment.[12]

The professional is particularly exposed when, for whatever reason, there is an excess supply situation in the market. Such conditions inevitably develop as a result of imperfect information available to those who are at the stage of deciding whether to invest in entering a profession. It is unreasonable to expect the long-term investment and entry process to work with sufficient precision to solve the price-setting problem.[13] Professionals are potentially exposed to price competition. They respond collectively by setting, suggesting and controlling price cutting. This of course may result in collusively set prices and incomes that are deemed too high. But competition can create the opposite problem. The first problem then, is that under conditions of excess supply, fully competitive forces could drive fees and incomes down to low levels. And the reason is that the individual professional who is not fully employed, has a low marginal cost for additional business. It is worth noting that such problems are not unique to the professions. Petroleum refining experiences period excess capacity. In these periods, prices are closer to average than to marginal costs, the former being significantly higher than the latter.

The pricing problem is further complicated by several factors. The society has a long-term interest in attracting high quality people to the professions, especially to the segments where quality is imperfectly perceived by the consumers. Generally, the segments serving individuals and households have the least informed consumers. It is a well established principle that in markets with consumers who discriminate imperfectly with respect to quality, the effect of competition is often to drive out the high quality suppliers.[14] In the professions, this would take the form of diverting talented

people to other careers, or other segments of the markets for professional services. This quality effect occurs when the reservation prices or incomes of professionals are positively correlated with quality. One might argue that in the segments that are likely to be afflicted with this problem the supply of quality has been maintained at an artificially high level because of the absence of competitive fee setting. The case could be further argued on the ground that the skills required to provide much of the service in the household segments are not as great as the current supply provides. This is a logical possibility. But it is not, by itself, an argument for unrestricted price competition. It does suggest that prices need not be equal in all segments. And one suspects, in lieu of concrete survey evidence, that there are price and income differentials across segments.

A variant of this problem occurs within the profession itself. It has been noted that the professional markets are segmented by size and knowledgability of consumers. Roughly this segmentation corresponds to the crude dichotomy between households and corporate clients. Competition with imperfect product differentiation will drive resources out of the sector where the perceptions are less precise, namely the household sector. This potential problem is exacerbated by the fact that in the corporate segments, product differentiation by reputation places natural economic limits on price competition.

This line of argument suggests that the maintenance of adequate quality and an adequate supply in the household segment justifies some control over price competition in that sector, where price competition is most likely to break out.

At this point, it is important to distinguish two factors that

affect the quality of professional services. They are the basic abilities of the individual on the one hand, and what we might call effort on the other. Effort is distinguished by virtue of the fact that the professional exercises some control over it. That is to say, it is discretionary. The preceding argument applies to ability. It implies that there may be difficulties in attracting high ability people to certain segments of professional markets under competitive conditions. But, maintaining prices above competitive levels does not solve the problem of discretionary aspects of service quality. Quality based on extraordinary effort will be rewarded only to the extent it is perceived. In the household segment, this problem, unlike the other, is endemic. It is not solved by controlling price competition, because controlled prices discriminate no better than competitive ones when consumers are poorly informed.

I mention this subject here because advocates of the status quo in the area of professional price setting have argued that price competition will result in a reduction in the quality of service provided by professionals, not because of exit, but because discretionary quality will fall. This may or may not be accurate. But the point I want to make here is that high price provides no positive financial inducement to raise quality. And in this respect, a high price and a low price are no different. The problem is the imperfect discriminating ability of the consumer, and the resulting absence of a correlation between prices and quality.

Representatives of professional organizations who have argued that excessive price competition will lead to a reduction in the quality of service available to individuals (especially in the segments with the more serious consumer information problems) have been vague about the precise reason.

The possible loss of talent to the corporate segments of the professions, or to alternative careers is a possible mechanism. As to the discretionary aspects of quality, the absence of price competition by itself does not ensure that the discretionary aspects of quality service are brought forth in an informationally impacted market. But there is a mechanism by which a reduction in fees through competitive pressure, can lead to distortions in the quality and character of professional services, through the effect of professional incomes. These distortions can be traced to the consumer information problem. It is a characteristic of professional markets that the supply side influences the demand for services by virtue of the fact that the professional functions as an informed adviser or agent to the client. The professional influences the client's perceived needs with respect to professional services. Under conditions of reduced income, professionals may expand the volume of services delivered to recoup some of the lost income, spending perhaps less time per task than previously, or delivering marginally necessary services.

The distortionary effects can occur as a result of price competition or because of excess supply conditions in a profession. Excess supply will have a depressing effect on incomes, much as will competitive pressure of fees. Studies of several professions suggest that these distortions do arise in the market segments serving the less well-informed consumers.[15] In fact price competition and excess supply tend to occur together as a result of excess supply. It is perhaps worth noting that the effects are exacerbated by insurance, which reduces the direct cost of marginal services to the consumer. Fortunately insurance is not a complicating factor in our professions, at least not yet.

To summarize, in professional markets or segments with imperfectly informed consumers, price competition tends to cause a deterioration in market performance, through a loss of talent to other segments, reduced quality of service, and the delivery of marginal services. Unregulated competition is likely to be excessive because the natural floor on prices, the point at which suppliers leave the market, is very low. The only significant variable cost for the professional is his/her own time. The long run adjustment process on the supply side will not solve the problem of talent moving to the corporate segments or out of the profession through the outlets mentioned previously.

The adjustments are too imperfect and sluggish to ensure that supply is properly matched to demand.

One is therefore led to conclude that there is a legitimate professional and public interest in avoiding unregulated price competition in the markets for professional services delivered to households. These segments are substantial and important particularly in law and accounting.

The recognition of a pricing problem does not of course lead to the conclusion that professions should be left free to determine fees collectively without further interference or oversight or at whatever levels they deem appropriate. It merely suggests that resort to the purely competitive model as an alternative to the present system, may have its own problems from the consuming public's point of view.

I am not proposing here that we substitute full-fledged price regulation for competition. There is, in place currently, a collection of informal mechanisms for controlling prices and fees. These take

the form of suggested fees and surveys of professional incomes which imply something about fees. The medical profession publishes surveys of incomes, work habits and so forth; these surveys serve as guides to the individual practitioner in setting fees, determining hours worked, and so forth.

In this author's view, such an informal system represents a reasonable adaptation to a complex problem. Only some services are standardized. A formal fee setting regulatory procedure covering non-standardized services would be costly and inefficient. It would lead to distortions of the type currently observed in medicine under comprehensive provincial health insurance schemes. It would also force the regulators to try to define categories of service in segments where the services are not easily classified.

What is needed is simply some oversight of professional incomes to ensure that the fee setting power is not abused in the form of unacceptably high overall income levels. Oversight of income levels will not embroil the public sector in a detailed service by service debate on fees, nor in defining standardized services. It would provide a measure of protection against inappropriate exercise of collective market power.

Such a scheme represents a less drastic departure from the status quo than would competition. As such, it is less risky, and accomplishes much the same objectives. It also permits the insertion of judgments about the appropriate degree of non-competitiveness in various parts of the market.

THE RESTRICTIONS OF ADVERTISING AND MARKETING

All four of the professions maintain and enforce rules prohibiting certain forms of advertising and marketing activity. These restrictions

are defended on several grounds. It is argued that imperfectly informed consumers are vulnerable to inflated or misleading claims by advertisers. It should be noted however, that this problem is by no means unique to the professions. In other markets, we rely on laws prohibiting misleading or fraudulent advertising to protect the imperfectly informed consumer, and the honest competitor.[16]

It is further argued that certain kinds of marketing activity are damaging to the image and dignity of the professions, the preservation of which is needed to maintain client confidence in these informationally impacted markets. Setting aside fraudulent or misleading advertising for the moment, I find the implicit suggestion that tasteful spot television advertising is undignified and unbecoming, simply remarkable. There are after all a rather large number of people and businesses throughout the economy who advertise. Advertising is one of the principal mechanisms that a market economy uses to inform its consumers of products, prices, retail locations and so forth.

The prohibitions on advertising, marketing, solicitation of others' clients and the like, are part of the regulatory mechanism whereby competition is held in check in professional markets. While I have argued that the competitive reduction of fees may lead to undesirable consequences, the control of price competition by eliminating advertising has potentially very high costs.

There is no question that bans on advertising reduce the incentive to cut prices, by reducing the quantity response and therefore the return to price cutting. But the problem is that this reduction in the return through an inability to communicate, applies not only to prices, but to any change in the product or service that is offered. Prohibiting marketing activity is the single most effective way to stifle innovation

in any market, including a professional one. It is especially damaging in consumer markets where the number of buyers is large, and media advertising is a cost effective method of communicating.

Innovation can and should take a variety of forms. It is convenient to divide innovations into three classes: cost reducing innovations, new product or service innovations sold to existing clients, and the development of a new market or market segments.

Cost reducing innovations are likely to occur through improved organization, or more efficient use of personnel and equipment. They may involve the adaptation of new technology (the computer for example) to aspects of professional tasks. They may also involve the use of paraprofessionals for certain aspects of the delivery of professional services. This subject is explored in detail in other reports to the Professional Organizations Committee. There is currently some incentive to engage in these activities but the incentive is considerably blunted when professional bodies respond negatively to organizational innovation and adaptation or restrict the innovator from marketing his innovation. This sort of innovation is potentially threatening to other professionals for several reasons. It can put pressure on prices and incomes, directly by reducing costs and indirectly by creating excess supply through economizing on professional inputs. And in other ways, innovation causes periods of transition in which innovators gain at the expense of others.

If the benefits of cost reducing innovations are to be passed on to consumers, then it must be possible for the innovator to reduce prices when some cost reduction has been achieved. And second, it must also be possible to advertise the reduced costs in the form of reduced prices. Under a regime of semi-regulated prices, the former can occur only if the regulatory body reacts favourably to cost based price reductions. The second part can occur only when the professional can advertise prices.

The developing of new markets and segments is the area that is most severely damaged by restrictions on market activity. New segments usually involve consumers who are not currently being reached. The marketing activity is absolutely essential to the process of communicating to the consumer about the character of the services, the costs, and the manner in which the interested consumer can avail himself of them. The evidence that one can piece together from the recent cases on advertising strongly suggests that in the household sector, there are large, legitimate, untapped markets especially in law and accounting.[17] In all but the highest income groups, the systematic use of lawyers and accountants for personal advice on matters ranging from wills, to taxes, estate planning and sound financial planning is extremely limited. These markets cannot be effectively developed without the ability to employ the normal marketing tools.

It has been suggested that collective advertising by the profession might open up some of these markets. I doubt it. If one wants business to buy and use mini computers, one does not normally rely on the computer trade association to develop the market. There are cases where "institutional" advertising is useful. The Oregon bar association publishes lists of practising lawyers. The consulting engineers in Ontario similarly collectively advertise. But when one recalls that successful innovation usually imposes some costs on other suppliers, it is simply unreasonable to expect there to be the kind of consensus required to sponsor collective advertising. Nor is there much reason to believe that advertising the benefits of one or a subset of the suppliers, should be paid for by all of them.

In this connection, it is interesting to note that income tax companies, of which the most successful is H&R Block, were developed by

non-professionals. But there is still, as far as I know, no comprehensive financial and estate planning service supplying lower and middle income needs. This market can probably be developed only with the active participation of lawyers and accountants.

In the case of new services for established clients, the marketing problem is slightly less severe. This kind of innovation, however, may be controlled by direct pressure from peers. The innovating professional is likely to attract other clients, through word of mouth channels among consumers. He will face pressure not to accept this sort of business as it involves indirect "solicitations" of others' clients. Innovative behaviour of this type upsets the apple cart. Like all innovation, it produces disequilibrium and periods of transition in which some are hurt. In other sectors, these are "costs" usually deemed well-worth paying for.

The problem of imperfectly informed consumers is not unique to the professions. It is characteristic of the markets for most consumer durables, for example. These other markets have occasional problems, including inflated advertising claims about products. But it is rarely suggested that advertising and marketing activities should be banned altogether. The only exceptions I can think of are the U.S. cigarette industry where television advertising was banned, and the provincial restrictions on liquor advertising in Ontario. Perhaps professional advertisements should all carry the warning "Consulting an X may be damaging to your pocket book." Even that is preferable to a total ban.

When a market fails in setting prices appropriately, there is evidence in the form of high incomes, and excessive rates of return. The failure to innovate leaves few traces and as a result, attracts little attention. One cannot observe directly something that might have

occurred, but in fact did not. Moreover, in the case of new markets, there is unlikely to be a consumer group clamouring for services except when, for other reasons, the need has become evident. Legal aid evolved to provide services to a group with clearly defined legal needs. But when one begins with the presumption that consumers are imperfectly aware of potential services and indeed to some extent their own needs, the social value of informative advertising increases, rather than the reverse. In view of these facts, it is an appropriate function of the regulatory process to create an environment that is conducive to innovation, and the development of new markets.

Some professional critics of the relaxation or elimination of advertising restrictions appear to take the view that there will be a spate of tasteless, misleading advertising, and more dire consequences thereafter in response to a relaxation of the advertising rules. It has been suggested that all advertisments will have to be screened by some review body; an admittedly monumental and expensive task.[18] I have three comments by way of response. First, the basic dignity and honesty of the vast majority of professionals is not an artifact of the current regulations. One would not therefore expect a flood of tasteless, undignified or misleading advertising. On the contrary, the social concerns and professional standards that are developed in the course of professional training, are quite likely to cause the abuses of advertising to be less in professional markets than they are in most other markets. The second comment is that unfair or misleading advertising is and should be subject to objections from other professionals. Such complaints can be processed by a modified version of the existing regulatory process. The third

remark is that while consumers may not be particularly well-informed, they generally do not believe everything they hear either. One should not exaggerate the gullibility and vulnerability of the public.

In fairness to the professions, it should be noted that innovation is a problem of concern in other regulated areas of the economy. Generally, limiting competition has a depressing effect on innovative activity. There is a reluctance by firms to introduce new products when the effect is in part to cut into the sales of existing products and to expose the innovator to increased risk.

There is a further problem in regulated industries that is deserving of comment. It is sometimes called "cream-skimming".[19] Cream-skimming occurs when the regulated firms are pricing services in such a way as to achieve higher rates of return in some market segments than others. If there is an institutional change that permits competition, the new entrants will enter the profitable segments, reducing the returns there and forcing prices up in the segments that were subsidized. For example, the telephone company is now exposed to competition from micro-wave transmission companies on the relatively profitable, high density intercity communication lines. Ultimately this will force an upward revision of prices in low density areas, which were previously subsidized by long lines.[20]

In the case of the professions, particularly law and accounting, the segments with corporate clients are more "profitable". And there may be some subsidization of the delivery of services to the household segments at the present time. Subsidization will occur if lawyers charge what the traffic will bear, at least to some extent, and if the corporate demand elasticity is lower than the elasticity of demand by individuals.

With the information currently available, it is somewhat difficult to be sure whether there is a pattern of imperfect subsidization or not. But patterns of pricing and implicit subsidization is not necessarily undesirable. It may correct to some extent for the tendency of households, to under-purchase certain kinds of professional services, a tendency that is traceable to poor information.

The question one must ask is whether the effect of a relaxation of restrictions on advertising and marketing is likely to alter this situation in ways that are inimical to market performance. On balance, the answer seems to me to be negative. The product differentiation mobility barriers provide protection for the established firms in the corporate sector. The largest untapped markets, it has been argued, are in the household segments where professional fees and incomes have generally been lower. It is in these segments that the social costs of restrictions on the forms of practice, and upon advertising have their greatest impact. It is these markets that have the properties of consumer goods markets, many potential highly dispersed buyers, none particularly large, and many imperfectly informed about the availability and characteristics of the products. Since innovation is most likely to occur in the subsidized segments, the cream-skimming problem will not arise.

If there were to be a cream-skimming problem, it would result from entry into the corporate segments. But the product differentiation entry barriers are likely to limit that sort of entry.

In discussing prices, I argued that there are legitimate problems with unregulated price competition in the segments with imperfectly informed consumers. This discussion provides an additional reason for controlling price competition. If the returns to innovations are bid away quickly by price competition, the incentive to innovate is

reduced, even under conditions where the serious marketing impediments to developing new markets have been removed. Thus the dual policies of removing marketing barriers to new market development, and of restraining price competition are largely complementary inputs to creating an environment that promotes progressiveness.[21] The marketing barriers referred to here include, specifically, bans on television and newspaper advertising, limitations on the legitimate use of paraprofessionals, limitations on the ability to practise with members of other professions, limitations on incorporation, to name a few.

ADVERTISING AND CONCENTRATION

Advertising is believed by industrial organization economists, to create entry barriers and thus to restrict potential competition and to increase industry concentration. Statistical studies confirm the hypothesis that advertising is associated with concentration and higher rates of return.[22] There remains some controversy with respect to causality; some maintain that high profits cause heavy advertising rather than the reverse.

The relevance of these findings in industrial organization for the profession is as follows. One might argue that advertising should be limited, because if it is not, the result will be high concentration and an absence of competition in segments which at present, exhibit very low levels of concentration. Here concentration refers to the extent to which larger suppliers have significant shares of the market.

There are two questions we need to consider here. One is whether advertising is likely to lead to increases in concentration in the segments serving households. The answer is probably yes. There are likely to be product differentiation advantages to establishing a reputation. Advertising makes that process easier. Moreover,

advertising is most efficient if undertaken by more than one professional. Therefore, grouping together will occur simply to take advantage of the returns to scale in advertising. The corporate segments already are more concentrated in part because of product differentiation considerations. Because of the concentration of the buying side, advertising and consumer marketing techniques are not necessary to achieve a product differentiation advantage.

Thus while one cannot be absolutely sure that advertising will promote increased concentration, it seems very likely.

The second and more difficult question is whether the anticipated increase in concentration is a change for the better or a change for the worse.

Of course, by itself, concentration is neither good nor bad. But it usually reduces the competitiveness of a market, and in that way, leads to undesirable effects. The judgment one must make here is whether the increase in concentration and market power, and the effects of that on prices are likely to outweigh the benefits of improved consumer information and the development of new markets. My own inclination would be to accept the increases in concentration; and perhaps insist that concentration not proceed too far. The Combines Investigation Act empowers the government to attack monopolies and near monopolies.

If the firm has a market advantage over the individual practitioner, then advertising may reduce the scope for the independent professional to practise. There may be some who regard this effect as too high a price to pay. I do not. In many other markets where there are advantages to size, the smaller seller is not protected. One needs a reason why the independent professional is of distinctive importance

as compared with other markets, in order to justify special treatment of the professions in this respect. This is an issue about which reasonable people can disagree. But as a basis for discussion, there is little doubt that advertising will increase concentration in many segments.

SUMMARY OF CONDUCT AND ITS REGULATION

Under the current system of self-regulation, prices or fees are set or suggested. The incentives for price competition are reduced by restrictions on marketing activity. The relevance of the Combines Investigation Act revision to the professions is a matter of dispute. But it certainly represents an assault on both the formal and informal collective fee-setting procedures and on the restrictive provisions with respect to advertising and other promotional activities. The view developed here is that marketing restrictions have a high cost in the profession with significant household or individual client segments. This cost is drastically reducing the ability to innovate profitably and successfully. But there is a legitimate interest of the public as well as the profession in regulating prices, to ensure an adequate and stable supply of talented professionals in the segments that are most exposed to the competitive reduction of incomes. It is sometimes argued that there has been an over supply of talent in the provision of routine services. That is quite possible, and consistent with the view taken here. The solution is not to endorse price competition to drive out the talented professionals, but rather to permit as a matter of regulation the use of qualified paraprofessionals trained for the specific tasks, and to allow any resulting cost reductions to be passed on to consumers. The appropriate regulatory strategy then is to ensure that fees are neither excessive nor deficient in these markets, and to

strike down the barriers to productive competition in dimensions other than price.

It is clear that these arguments apply to the professions in proportion to the magnitude of the potential non-corporate markets. Both law and accounting have significant non-corporate clienteles. Architecture has a smaller, but significant non-corporate, non-government market. Engineering does not. Moreover, it is my impression that the restrictiveness of the regulations governing engineering is less than in the other three professions. Competing for business is a normal practice in engineering. While there are fee schedules and attempts to control price competition, the evidence in another report prepared for the Professional Organizations Committee suggests that this attempt to control fees is only partially successful."[23]

One cannot help noting that in architecture, there is a significant excess supply problem. There is also a perceived (on the part of architects) encroachment of engineers into architects markets. But there is the further problem that the rigid restrictions on professional conduct in architecture deprive the underemployed architect of the weapons that would be required to develop new lines of business. For example, architects must practise individually or in a partnership with architects. They cannot therefore form a partnership with engineers, urban planners, and other professionals, to provide a mix of services that would increase their marketability. One cannot pre-judge the extent to which there are untapped potential markets for architectural services. But one can be reasonably confident that under existing regulation, architects are unlikely to be able to find and exploit them profitably.

THE PROBLEM OF EXCESS SUPPLY

In an earlier section, the potential problem of excessively restrictive entry was discussed. We concluded that the available evidence did not point toward a problem of restrictive entry in these professions.

There is a possibility that the opposite problem will arise. There can be excess supply. This is perhaps the most difficult problem with which to deal, because the clear identification of an excess supply condition is difficult in all but the most extreme cases.

It is useful to begin by reviewing the various conflicting effects of excess supply.

An excess supply of professionals will put pressure on fees and incomes in the segments not protected by mobility barriers. If the pressures on fees are resisted by collective regulatory action, two secondary effects may occur simultaneously. There can be underemployment of professionals and there can be expansion of demand because of the partial control over demand exercised by the supply side. There may also be innovation and the development of new markets. Without having enormous quantities of information at one's disposal, it is difficult to distinguish the legitimate expansion of demand that results from the provision of new and useful services from the unnecessary expansion of services of the sort that would not be purchased by fully informed consumers in a competitive market.[24] These two effects are difficult to distinguish.

Excess supply will give rise to increased collective pressure from the profession to control competitive conduct, so that the marketing activities identified earlier as a prerequisite for certain useful kinds of market development are likely to be restricted.

Taking these factors together, one is lead to the conclusion that the professions and the public have a collective interest in preventing excess supply conditions from developing. The problem is only partially taken care of by the fact that the members of these professions have alternative forms of employment to which they turn when professional opportunities are limited. The remainder of the burden falls on the regulatory process. Some attempts to improve the flow of information to aspiring professionals about expected future market conditions would meet some of the problem.

The problem of detecting an excess supply condition is complicated by several factors. Under a system of partially controlled prices, one facet of normal market adjustment is removed. While deficient supply may result in high incomes, excess supply will not necessarily result in low incomes or underemployment expecially when demand tends to expand or contract with supply conditions. Perhaps the best limited evidence of excess supply, other than underemployment, would be an abnormally high outflow of professionals to alternative forms of employment. In the end there seems little alternative to attempting to judge directly the benefits and costs of the marginal services being provided in the market.

THE CONFLICT OF INTEREST BETWEEN CLIENT AND PUBLIC

Although the regulatory problem is complex enough as a result of imperfect information, it is further complicated by the fact that the delivery of professional services affect many people other than the clients. This is a feature of all four professionals with which we are concerned, in some degree. The financial community consumes the services of accountants. All the professions, in the course of delivering services to the public, certify that certain activities have been

carried out according to standards that are designed to meet and protect the public interest.[25]

Since the meeting of standards is costly for professional clients, there is a potential divergence of interest between the client and the public. The professional stands between these two interests, acting to some extent as an intermediary and an arbiter.

It is argued plausibly that the balance that is struck between the client's interest and the public's interest is likely to be tilted more toward the client as the power of the professional in the market declines relative to the client. In the fact of competitive pressure, it is more difficult to maintain standards that are designed to protect the public's interest.

There are two polar solutions to this generic problem. One is to remove the competitive pressure. The other is to maintain the standards by vigorous regulatory activity. Neither is a perfect solution. A balance must be struck between them. The withdrawal of competitive pressure serves neither present nor potential future clients, although it has been argued that a reasonable case for controlling price competition can be made. On the other hand, relying exclusively upon the frequent and careful review of professional conduct to enforce professional standards in the name of the public interest is expensive and cumbersome. It is also degrading to the vast majority of professionals whose enjoyment of their professional life derives in part from serving clients while maintaining high standards of professional conduct.

There are several steps that can be taken to ensure that a reasonable balance is struck between these competing objectives. First, the formal regulatory apparatus should include, to a greater extent than at present,

non-professional representatives of the public. This step would serve not only to ensure that the public interest is represented, but also to protect the professions from the inevitable impression that a closed regulatory process is self-serving.

Second, while no one wants to place professionals in the position of having to choose between the client and the public interest, or between ethics and income, the control of competition will not solve the problem of the minority of unscrupulous members of the profession who are prepared to set the standards aside. For this problem, one needs an efficient process for identifying and disciplining the offending parties. This process will be facilitated if it is regarded as the clear responsibility of the individual professional to report violations of accepted professional conduct, and not simply keep his or her house clean. It will also be easier to enforce standards if there are non-professionals in the regulatory bodies to whom a responsibility will be felt for enforcing the rules.

To summarize briefly, it seems clear to this observer that the regulatory bodies in the four professions do not presently include sufficient, responsible "outside" representation, and that the result is a combination of an actual and perceived imbalance in the promotion of the interests of the professions, and their clients relative to the interests of the public. Second, setting aside all forms of competition is neither necessary nor sufficient for accomplishing the objectives of protecting the public interest.

CONCLUSIONS AND RECOMMENDATIONS

In the courts, and in other adversary proceedings, where much of the debate about professional markets occurs, the views are understandably extreme. The professions are either grappling with the regulation of

difficult markets, or they are self-servingly eliminating competition and exploiting the privilege of self-regulation to their advantage. Neither view is true, nor particularly useful. The interests of those who are affected directly or indirectly by the regulation of these markets (and that is most of us) are not coincident. The history of regulation represents a balancing of these interests.

In the past, the professions have had rather more autonomy than was perhaps desirable. In Canada, the pendulum appears to be swinging rather rapidly the other way. Apart from the fact that sudden changes in the rules can be unfair, and harsh in their inpact on people, there are reasons to pause before fully accepting competition as the new regulatory mechanism in these markets.

Competition has its place. I have attempted to argue that the benefits outweigh the costs for the removal of restrictions on advertising and marketing. I am much less sanguine about the removal of the fee setting devices, and indeed the removal of the right of the professions to regulate fees. This is not to say that there should be no recourse in case fees are collusively maintained at unreasonably high levels. I argued earlier that periodic review of incomes by a regulatory body that includes non-professionals might accomplish the desired effect.

The removal of some of the restrictions in the area of conduct, combined with the acceptance of a common interest in a relatively stable market populated by talented people on the supply side, represents a reasonable balancing of the interests of the professions and their clients.

In the area of the representation of the public interest, a shift in the direction of increased non-professional representation on the

regulatory bodies without eliminating the professional oversight, would improve not only the effectiveness of the process in balancing interests, but also the authority and legitimacy of the process from the public's point of view.

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FOOTNOTES

1

The author wishes to thank the Professional Organizations Committee Staff, and the other investigators employed by the Committee for their contribution to assembling and organizing the facts and issues. Their work was of considerable help in organizing my thoughts here. See Appendices A,B,C, and D to Research Directorate's Staff Study, "History and Organization of the Accounting, Legal, Architectural and Engineering Professions in Ontario (respectively), (1978). See also other working papers prepared for the Professional Organizations Committee.

2

The literature on the professions is considerable. A sample of the writing I found useful is contained in the references accompanying this report.

3

This paper does not deal with paraprofessionals in detail. However, the issue does arise in the discussion of innovation, and the opening of new markets.

4

Gordon Kaiser, "Federal Competition Law and the Professions: Problems in Jurisdiction," in The Professions and Public Policy eds. Michael J. Trebilcock and Philip Slayton (Toronto: University of Toronto Press, 1978).

5

The entry requirements vary considerably in detail. For a discussion see the Appendices to the Research Directorate's Staff Study. op. cit.

6

Freeman [1975] discusses the cycles in supply and demand that have characterized the legal profession in the U.S. Similar direct evidence is not available for Canada. The cyclic pattern is likely to be duplicated because of the structural similarities in the markets and the forms of regulation.

7

The concept of mobility barriers is developed in Caves and Porter [1977].

8

See Brock [1975] for a discussion of these advantages based on reputation and established track record in the computer industry.

9

Similar remarks apply to the legal profession. See for example, Green and Nader [1977] for a discussion of the established legal firms and their corporate clients.

10

Reference to the Metcalf Report.

11

The differentiation by reputation is common to many markets with imperfectly informed consumers. For example, in most consumer durables markets, the established firms and brands have significant advantages.

Of course, the maintenance of the reputations provides an incentive to deliver the quality.

12
There are, of course, other careers that are typically preceeded by an investment in education is not tailored so specifically to a particular market or set of jobs. The nearest analogue to professional training is probably training in the trades. And it is interesting to note that there are (as a result of trade union action) restrictions on entry and control over prices, much as in the professions.

13
Freeman [1975] shows that there are lags in the response of supply to demand. As a rough approximation, the adjustment period appears to be at least five years long.

14
This phenomenon results from the fact that high ability people go where the abilities are appreciated and rewarded with higher income. They therefore tend to leave markets where they are treated as if they were near the average. This kind of market problem was discussed in a very useful way by Akerlof [1970]. It is now recognized as one of the principal problems that a market with imperfectly informed consumers may have. In particular, the prices in such markets tend to be too low.

15
Studies of dentistry have turned up problems of unnecessary services. See Friedman [1975]. Similar effects are believed to operate in the medical care system when the supply of doctors increases, as it did in Canada with the advent of National Health Insurance.

16
In the U.S., it is the responsibility of the FTC to control deceptive advertising. In Canada, this regulatory function is performed by the provinces. It should be noted that the honest seller suffers as a result of deceptive advertising by the competition, in two ways, lost business, and loss of reputation insofar as the misbehaviour or a rival is believed by consumers to be characteristic or typical of the industry in general.

17
A recent court case concerning advertising by lawyers, Bates and O'Steen v. The Arizona Bar Association, involved an attempt to attract the public to a legal service clinic-type operation, targeted to lower middle class clients who tend to underutilize legal services. For a description, see the American Bar Association Journal, "To Advertise or Not to Advertise," March 1977.

18
This view was reportedly expressed for example, by John P. Frank in the American Bar Association Journal, "To Advertise or Not to Advertise," March 1977.

19
For a description of the "cream-skimming" problem, see Kahn [1968].

20

This is part of the argument made by AT&T before the FCC concerning competition from MCI and other companies, in intercity communications.

21

It is possible to make the case that a new product introduction can be hampered if the price cannot be cut for a period while the produce gains acceptance. This is, pricing itself is a marketing tool. This is true. My view is that if the other tools are made available, the inability to price cut will not generally be the deciding factor. And as we have seen, price cutting has other costs which one wants to avoid.

22

See W.S. Comanor and T.A. Wilson, Advertising and Market Power (Cambridge: Harvard University Press, 1974) for the most complete study of these issues.

23

See "An Analysis of the Practice of Architecture and Engineering in Ontario", Working Paper #1 prepared for the Professional Organizations Committee, 1978.

24

Generally excess capacity in the form of management personnel in business organizations has been a stimulus to innovation. DuPont for example, began its highly successful period of diversification and innovation with the excess capacity that result from the decline of the explosives business after World War I. An excellent account is given in Chandler.

25

Engineers and architects are responsible for ensuring that buildings meet design and materials standard that ensure safety. Accountants certify that the process whereby corporate financial records are kept and reported meet generally accepted principles. And lawyers must ensure that contracts are legal and meet certain minimal requirements of completeness and accuracy. In fact, all four professions have clearly defined responsibilities to the public that extend beyond their obligations to clients.

APPENDIX

The Main Points of the Metcalf Report* on the Accounting Profession in the U.S.A.

The purpose of this appendix is to summarize the principal points in the analysis of the Accounting Profession carried out by a Congressional Subcommittee in 1976. It is often referred to as the Metcalf Report.

1. The Big Eight dominate the accounting profession and audit all major corporations.
2. The Big Eight influence government accounting standards, and the standards set out by the AICPA and FASB.
3. The firms audit, give tax advice and provide consulting services.
4. There is considerable discretion in the selection of standards by the independent auditor.
5. Concentration in auditing appears to be increasing because of corporate mergers.
6. The Big Eight have become involved in the business affairs of their clients. As such they are not perceived to be "independent."
7. The Big Eight control the AICPA because of its committee structure, and hence have a disproportionate influence on the entire profession.
8. The AICPA is active politically in keeping the government out of the profession's affairs.
9. The AICPA and the Big Eight control FASB, where the standards are set.
10. The SEC has the authority to influence reporting standards, but does not use this authority.
11. The Big Eight serve the corporate clients, not the investing community or the public.

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* United States Congress, Senate Committee on Governmental Affairs, Subcommittee on Reports, Accounting and Management, The Accounting Establishment; A Staff Study (Washington, D.C., Government Printing Office, March, 1977).

12. The Big Eight offer a full range of consulting services and derive between five and sixteen per cent of their income from these.
13. Auditing is highly concentrated. As a result, it is not very competitive. The consulting arms have an advantage over competitiors. They collude to influence Congress.
14. Small firms are displaced when corporate mergers occur. This tends to increase concentration.
15. The Big Eight represent corporate clients before Congress and the regulatory commissions. This is perceived as expert testimony, when it is really an advocacy position.
16. The overall impression is that the Accounting Profession is dominated by 8 large firms whose interests are identified with their corporate clients, and in whose interests they are. The solution is to break up the firms to achieve less concentration, and to remove some of the power of the AICPA.

Comments: My view is that the report is one-sided and probably unfair. This is not to say that there are no problems. But the other side of the story is not very well represented here. The part I have difficulty with is the propositon that the Big Eight are out for themselves and their clients. This may be true, but it seems to me not to have been proved. The documentation of the increasing concentration is interesting, and a matter of concern.

Appendix: The Problems with Prices and Imperfect Quality Discrimination

This appendix provides some technical analysis relating to competiton in segments where consumers do not perceive quality differences among suppliers. We assume that in the long run, average quality is detected by consumers. My aim here is to determine the circumstances under which it would be desirable to have prices above the competitive levels in these markets.

<u>The Model:</u>

The variables in the model are as follows. The income of the professional is y. The price for the services is p. We measure services in terms of the output of a fully employed professional. Average quality is Q and it depends on y: we write $Q(y)$. Demand is a function of price p, and qualtiy. It is written $D(p,Q)$. The average qualtiy rises with income, so that $Q'(y) > 0$. Finally $N(y)$ is the supply of professionals. It is a rising funciton of income.

We measure benefits using consumer and producer surpluses. The consumer surplus is

$$\int_p^{\infty} D(v,Q)dv.$$

Producer benefits are

$$\int_0^y N(v)dv.$$

And if revenues and incomes are different, perhaps because of taxes, the government surplus (it may be negative) is

$$pD - yN\ .$$

Thus the total net benefits are

$$T = \int_p^{\infty} D\ dv + \int_0^y N\ dv + pD - yN.$$

Naturally, in any market equilibrium $N \geq D$: The supply must equal or exceed the quantity actually delivered.

I want to begin by discussing the optimal settings of p and y. This is of interest because it illustrates what goes wrong with the competitive market. Maximizing T subject to $N \geq D$, with respect to p and y, yields the following conditions.

$$D = N$$

$$Q' \int_p^{\infty} D_Q \, dv = (y - p) N' .$$

The second of these conditions implies that $y > p$. That is the optimal price or income to the supplier is higher than the charge to consumers. The reason is that the elevated supplier price raises the quality without choking off demand.

In a competitive equilibrium without interference, $D = N$ and $p = y$. This equilibrium can be improved by raising y to increase average quality.

The markets with which we are concerned are neither perfectly competitive, nor optimally regulated. What we have instead is a situation in which prices are raised above competitive levels by cooperative behavior. As a result $D \neq N$. On the other hand, all revenues are transformed into professional income so that $pD = yN$. So the quesiton is this. Does the raising of p above competitive levels improve market performance?

Differentiating net benefits with respect to p, we have

$$\frac{dT}{dp} = -D + (Q' \int_p^{\infty} D_Q \, dv + N) \frac{dy}{dp}$$

where $\frac{dy}{dp}$ is determined by the relationship $pD = yN$. Note that if $\frac{dy}{dp} = 1$, then

when D = N, which is true at the equilibrium $\frac{dT}{dp} > 0$, so that a price above the competitive price would be preferred. If $\frac{dy}{dp} \lessgtr 0$, then $\frac{dT}{dp} < 0$, so that a rise in p would reduce welfare. Note however, that if $\frac{dy}{dp} < 0$, then the profession is unlikely collectively to raise prices, since it decreases individual incomes

From $pD = yN$, one can calculate $\frac{dy}{dp}$. It is

$$\frac{dy}{dp} = \frac{D(1 - \eta)}{N(1 + \beta) - pD_Q Q'}$$

Here

$$\eta = \frac{-pD_p}{D},$$

the price elasticity of demand and

$$\beta = \frac{yN'}{N},$$

the supply elasticity.

We can simplify this expression by looking back at the determinants of Q(y) and N(y). If f(z,q) is the joint distribution of reservation prices and quality in the population of potential professionals, then

$$N = \int_0^y \int_0^1 f(z,q)\, dqdz$$

where q varies between zero and one.

In additon

$$Q = \frac{1}{N} \int_0^y \int_0^1 qf(z,q)\, dqdz.$$

Using these formulae, it is easily verified that

$$Q' = \frac{N'}{N}\,[E(y) - Q]$$

where E(y) is the expected value of q given z=y. That is, it is the average quality of people whose reservation income is just at the income in the market. If the actual income dropped slightly, this gourp would leave.

Let $\gamma = \frac{QD_Q}{D}$. Using the fact that at an equilibrium D=N, the derivative $\frac{dy}{dp}$ becomes

$$\frac{dy}{dp} = \frac{1 - \eta}{1 + \beta - \beta\gamma(\frac{E(y)}{Q} - 1)}$$

The effect of a change in p on y depends on several parameters: both demand elasticities, the supply elasticity, and the extent to which quality and reservation price are correlated.

A large positive impact is likely when η is small, γ is large and $\frac{E(y)}{Q}$ is large.

Perhaps the most useful points to note are these. First, there is no guarantee that raising the price will improve matters, given that the incomes are tied to revenues. Second, the strategy of raising the price is least likely to be beneficial, when the price elasticity of demand is fairly large, or the quality effect is small.

Note that $\frac{dy}{dp}$ can be positive so that the professions have an incentive to raise p, while $\frac{dT}{dp} < 0$. For a price rise to be benficial, it is not sufficient that $\frac{dy}{dp}$ be positive. It must be large enough to outweigh the negative impact on demand of a price rise.

Lest there is any confusion at this point, let me emphasize that when $\frac{dT}{dp} < 0$, it does not follow that competiton is a good thing. What is needed is a subsidy in the relevant markets so that quality can be attracted on the supply side without driving demand down.

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